LRBa1279

2001 DRAFTING REQUEST

Senate Amendment (SA-SB375)

Received: **02/13/2002**

Received By: **kahlepj**

Wanted: **Today**

Identical to LRB:

For: **Roger Breske (608) 266-2509**

By/Representing: **Vaughn Vance**

This file may be shown to any legislator: **NO**

Drafter: **kahlepj**

May Contact:

Addl. Drafters:

Subject: **Insurance - miscellaneous**

Extra Copies:

Submit via email: **YES**

Requester's email: **Sen.Breske@legis.state.wi.us**

Carbon copy (CC:) to:

Pre Topic:

No specific pre topic given

Topic:

Deferred annuity minimum nonforfeiture interest rate

Instructions:

See Attached

Drafting History:

Vers.	Drafted	Reviewed	Typed	Proofed	Submitted	Jacketed	Required
/?	kahlepj 02/13/2002	gilfokm 02/13/2002		_______ _______			
/1			jfrantze 02/14/2002	_______ _______	lrb_docadmin 02/14/2002	lrb_docadmin 02/14/2002	

FE Sent For:

<END>

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/?	kahlepj	/1 - kmg	jf 2/14	sell 2/14			

FE Sent For:

<END>

Kahler, Pam

From: Vance, Vaughn
Sent: Wednesday, February 13, 2002 4:44 PM
To: Kahler, Pam
Cc: Kiel, Joyce
Subject: OCI "Technical Bill"

Pam:

I hope you are as pleased as me that I got everyone to sign off on the "incorporation by reference" amendment that you and Joyce worked out. I am attaching a copy of an additional amendment that we are being pressed to offer. The amendment relates to reserve requirements for annuities. They want to reduce the requirement to 1.5%. I have some concerns about it, but am being pressed to offer it. OCI has signed off as well.

Roger wants to paper ballot it tomorrow. He asked me see if you could draft the amendment so that after he meets with the interested parties, he would be able to offer it and still get it reported out. I said I would ask that you rush it, but that this was an incredibly busy time.

Thanks for whatever help you can give.

VAUGHN L. VANCE for
Senator Roger Breske

Annuity Minimum
Interest Rate1...

Northwestern Mutual™

Steven M. Radke
Legislative Representative
414-665-2072

Annuity Interest Rates

Proposal for Reduction of Standard Nonforfeiture Rate Minimum for Individual Fixed Annuities

Issue

The 3% minimum interest rate guarantee required by the Standard Nonforfeiture Law for individual deferred annuities is incompatible with the current low interest rate environment which may extend for a protracted time.

Background

A. Some Definitions

Annuity - An annuity is periodic payment that can begin at a specified date or can be contingent on a particular event and continue throughout a fixed period or for the duration of an individual's life. The income under an annuity contract may be paid annually, semiannually, quarterly, or monthly, depending upon the agreement.

Where the primary function of life insurance is to *create* an estate or principal sum; the primary function of an annuity is to *liquidate* a principal sum, regardless of how it was created. It is often said that life insurance protects you from dying to soon, whereas an annuity protects you from living too long (and outliving your resources). Life insurance and annuities are based on the same fundamental pooling, mortality and investment principles.

Nonforfeiture Law - All states have laws that stipulate certain requirements that insurers must meet in calculating reserves and surrender values for the products they offer. Nonforfeiture laws define minimum cash surrender values -- the amount of refunds available to a consumer if they terminate the contract before maturity. These laws assure policyowners who voluntarily terminate their contracts a fair share of the value built up in their insurance policies or annuities. Refunds required by such laws are called nonforfeiture values. Most states' nonforfeiture laws (including Wisconsin's) are patterned closely after model laws drafted by the National Association of Insurance Commissioners (NAIC).

Standard Nonforfeiture Law does not require specific surrender values. The only requirement is that surrender values are at least as large as those that would be produced by the method the law prescribes. In addition, each annuity must contain a statement of the method used to find the nonforfeiture values and benefits provided under the annuity.

B. Current Wisconsin Nonforfeiture Law for Annuities

Wisconsin's nonforfeiture law for annuities is contained in Wis. Stats. §632.435. This section states that the minimum surrender amount prior to the beginning of annuity payments shall be equal to the amount paid by the annuitant, along with 3% annual interest (minus any prior withdrawals and several other articulated elements). §632.435(4)(a).

The Problem

A. Historical Context For Three Percent Choice:

To support annuities, life insurance companies typically invest in short- or medium-term (e.g., 3-5 year) corporate bonds or other fixed income investments. Accordingly, Treasury Rates in the one to five year range serve as relative benchmarks for annuity credit rates.

The 3% "floor" for annuities in standard nonforfeiture law was adopted by the NAIC in December of 1976. Since late 1972 the Five Year Treasury Rate had remained well over 6%, attained mid 8% levels repeatedly during '74 and '75, and was hovering at the time of the NAIC's action in the 7 – 7 ½% range. Prior to 1976, the individual deferred annuity market was small; few states even had a nonforfeiture law applicable to annuities, and those which did generally required a nonforfeiture minimum lower than 3%.[1]

In the mid 1970's, the predominant expectation--and the paradigm under which most regulators and economists operated--was that of continuing higher interest rates and potential inflation. A draft proposal from the American Council of Life Insurers at that time stated,

> Economists generally indicate that interest rates are likely to continue to fluctuate around their current high levels [then around 7.5% for 5 year Treasury Bills] for the indefinite future. Therefore, it is recommended that the statutory interest rates in the Standard Valuation and Nonforfeiture Laws *again be increased* to bring these laws more into line with current economic realities and with those of the foreseeable future [emphasis added].[2]

The 1970's mindset that higher interest rates would continue as the norm for the foreseeable future was also documented in the following NAIC Proceedings text:

> Economists today generally view long-term interest rates as consisting of two parts, a basic "real" rate of interest and an inflation premium. The basic "real" rate of interest...has remained relatively stable over several decades at about 3 ½%. However, some economists believe that a growing capital shortage may push the basic "real" rate about *one-half percent higher* in future years ...Translating expectations of inflation averaging about 5 ½% and a basic "real" rate of return on capital of 3 ½% or more into yields on high grade long term bonds leads most economists to believe that yields will be in the 8% or 9% range for the foreseeable future. *In fact there is a general consensus among economists that we are unlikely ever again to see the 4% to 6% yields that characterized high grade bonds during the 1960's* [emphasis added].[3]

NAIC testimony portrays the environment within which regulators chose 3% as a true "floor" (that bottom level below which nothing can reasonably go) for nonforfeiture rates. Such minimum was the result of the open acknowledgment that the threshold assumption of any future "real" rate of interest available to the insurer would always be at least 3 ½%. Three percent was fifty basis points **below** that threshold. The 3% legislative mandate was therefore an intentionally conservative floor, chosen with the expectation that it would never be reached.

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[1] NAIC Proceedings – 1976 Vol. 2. Attachment E-1, at page 628.
[2] NAIC Proceedings – 1977 Vol. I, Attachment G4, at page 600
[3] Ibid. at page 602

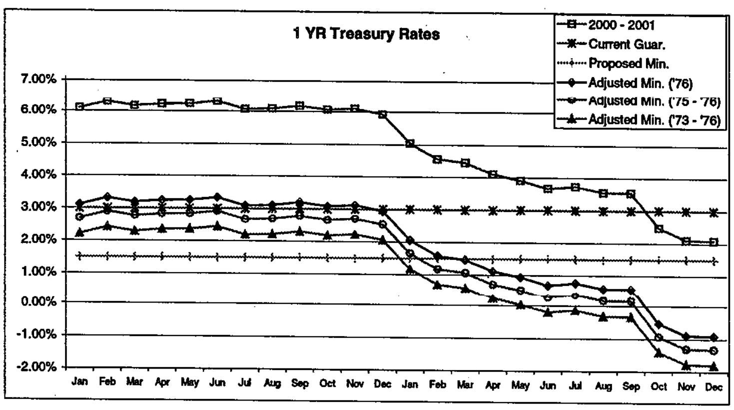
B. Today's Realities:

- Today, the five year Treasury rate --at 7½% in 1977-- now hovers around 4%.
- On December 11th, the Federal Reserve cut short-term interest rates below 2% for the first time in 40 years.
- Federal regulators "left the door open for more cuts, signaling that while officials see glimmers of hope, they remain skeptical of the idea that the recession is almost over."[4]
- The Federal Reserve cut rates eleven consecutive times during 2001[5].
- The eleven cuts are the most in any one calendar year since the Fed started targeting the federal funds rate as an instrument of monetary policy in the 1970s.[6]
- Each decrease during 2001 was either 25 basis points or 50 basis points.
- Cumulative reductions during 2001 totaled 4.75 percentage points.[7]

Key Factors Driving the Need for Change

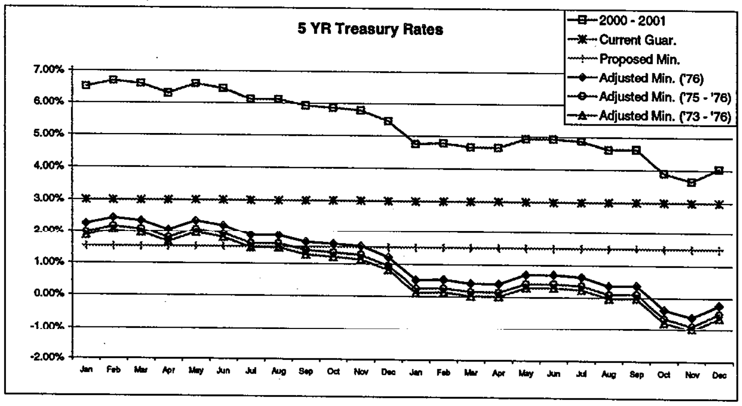
A. Loss of Acceptable Range Between Imposed Minimums and Current Market Rates:

The following graphs compare Treasury Rates (one and five year) in effect from 2000 through 2001, in relationship to the required minimum rate of 3%, as well as to an alternative minimum rate of 1 ½%.



1 Year			
Period	Average	Minimum Guarantee	Difference
1976	5.99	3.00%	2.99%
1975-1976	6.40	3.00%	3.40%
1973-1976	6.88	3.00%	3.88%

[4] Greg Ip, *Fed Slips Interest Rates to 1.75%, Leaves Door Open for More Cuts*, WSJ, December 12, 2001 ["Ip article"]
[5] Ibid.
[6] *Fed cuts rates a quarter point*, CNNfn, December 11, 2001
[7] Ip article



5 Year			
Period	Average	Minimum Guarantee	Difference
1976	7.25%	3.00%	4.25%
1975-1976	7.52	3.00%	4.52%
1973-1976	7.65	3.00%	4.65%

Also displayed in each graph are three "adjusted minimums" from identified time periods leading to the adoption of the 3% standard nonforfeiture law minimum; the tables above list the average interest rate for each of the three periods. These three entries in each graph illustrate the established relationship during the mid 1970s between then-current Treasury rates and the required standard nonforfeiture law minimum, as well as the erosion in the past year of such range between current Treasury Rates and the mandated 3%.

For example the average five year Treasury rate in 1975-1976 was 7.25%; that number, minus the minimum mandated 3%, is 4.25%. That result [4.25%] is the "constant" difference between the mid-70's current and the mandated minimum rate. As shown in the graphs, during the early to mid 1970s, then-current One Year and Five Treasury Rates were always higher than the mandated minimum standard nonforfeiture law rate by a range of about 3 to 4 ½ %.

In contrast, consider the relationship during the years 2000-2001 between the current one year/five year Treasury rates and the mandated 3% minimum. In the five year graph, the gap between Treasury rates and that minimum shrank from about 3 ½% at the beginning of 2000, to as little as ½% in late 2001. The one year Treasury rates, while more volatile, hovered around 3% higher than the minimum until 2001, at which time rates plunged below the minimum required by the standard nonforfeiture law by about one percentage point.

These charts, in simplified fashion, illustrate the significant breach of an acceptable gap between Treasury rates and interest minimum requirements. Such erosion acts to negate a threshold aspect of annuity product designs during the last 30 years.

B. Responsible Planning for Low Probability/High Severity Event

Given the historic lows and high volatility of recent interest rates, fluctuations in the stock market and other problematic economic indicators, it is of course not possible to state with absolute certainty whether interest rate levels, going forward, will remain dramatically low. As part of responsible planning for future contingencies, however, insurers must be prepared for possibility of interest rates remaining low and perhaps dropping lower, and the severe impact that would result.

Going forward, it is important to note that experts disagree as to the prospects for a recovery or on the direction of interest rates. The Wall Street Journal recently noted:

Trading in the futures markets suggests that investors put 38% odds on another quarter point cut at the Fed's Jan. 29-30 meeting, and that they expect the Fed to start raising rates during the second quarter. That puzzles many economists who expect the Fed to at least keep rates low through most of the next year, if not to continue cutting. "It's hard to find the individuals who have the actual policy expectations that seem to be implied by market rates", said Lou Crandall, chief economist at Wrightson Associates, a fixed-income research concern.[8]

Requested Action

Given the facts outlined above, Northwestern Mutual, along with the American Council of Life Insurers, requests that Wisconsin change the nonforfeiture law for annuities to lower the required minimum interest rate to 1½% on new policies. Draft legislative language that would have that effect is attached.

It should be noted that this proposal ***would not alter in any way*** in force contracts. However, going forward with new contracts, in order to responsibly offer many types of annuity product designs, companies need relief from the 3% minimum requirements.

NAIC Activity

A subgroup of the National Association of Insurance Commissioners Life Committee held a conference call on Friday January 23rd, and agreed to support legislative efforts to reduce the annuity nonforfeiture minimum interest rate. The full National Association of Insurance Commissioners is expected to ratify this decision in the very near future. This subgoup will also be recommending to the NAIC that a study be conducted this year to develop a long-term solution to this problem.

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[8] lp article

Suggested Amendment to §632.435(4)(a)

Section XXX. 632.435 (4)(a) of the statutes is amended to read:

632.435 (4) (a) With respect to contracts providing for flexible considerations, the minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to such time at a rate of interest of ~~3~~1.5% per year of percentages of the net considerations paid prior to such time, decreased by the sum of any prior withdrawals from or partial surrenders of the contract accumulated at a rate of interest of ~~3~~1.5% per year and the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract. The net considerations for a given contract year for purposes of this subsection shall be an amount not less than zero and shall be equal to the corresponding gross considerations credited to the contract during the contract year less an annual contract charge of $30 and less a collection charge of $1.25 per consideration credited to the contract during that contract year. The percentages of net considerations shall be 65% of the net consideration for the first contract year and 87.5% of the net considerations for the 2nd and later contract years, except that the percentage shall be 65% of the portion of the total net consideration for any renewal contract year which exceeds by not more than 2 times the sum of those portions of the net considerations in all prior contract years for which the percentage was 65%.

State of Wisconsin
2001 – 2002 LEGISLATURE

LRBa1279/1
PJK:kmg

~~PRELIMINARY DRAFT – NOT READY FOR INTRODUCTION~~

Thurs am

SENATE AMENDMENT ,

TO 2001 SENATE BILL 375

At the locations indicated, amend the bill as follows:

1. Page 2, line 4: after "insurers," insert "reducing the minimum nonforfeiture interest rate for fixed individual annuities,".

~~**2.** Page 8, line 25: after "??" insert "??".~~

3. Page 8, line 25: after that line insert:

"SECTION **21m.** 632.435 (4) (a) of the statutes is amended to read:

632.435 **(4)** (a) With respect to contracts providing for flexible considerations, the minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to such time at a rate of interest of ~~3%~~ 1.5% per year of percentages of the net considerations paid prior to such time, decreased by the sum of any prior withdrawals from or partial surrenders of the contract accumulated at a rate of interest of ~~3%~~ 1.5% per year and the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract. The net considerations for a given contract year for purposes of this subsection shall be an amount not less than zero and shall be equal to the corresponding gross considerations credited to the contract during the contract year less an annual contract charge of $30 and less a collection charge of $1.25 per consideration credited to the contract during that contract year. The percentages of net considerations shall be 65% of the net consideration for the first contract year and 87.5% of the net considerations for the 2nd and later contract years, except that the percentage shall be 65% of the portion of the total net consideration for any renewal contract year which exceeds by not more than 2 times the sum of those portions of the net considerations in all prior contract years for which the percentage was 65%.".

History: 1977 c. 153; 1979 c. 110 s. 60 (13).

4. Page 11, line 12: after that line insert:

"(4) INTEREST RATE FOR INDIVIDUAL DEFERRED ANNUITIES. The treatment of section 632.435 (4) (a) of the statutes first applies to annuity contracts issued on the effective date of this subsection.".

(END)